APPENDIX

James L. Kichline
July 12, 1983

FOMC BRIEFING -- INTRODUCTION

During our presentations this afternoon we will be referring to the package of charts distributed to you. The first chart displays the monetary aggregate assumption and associated interest rates that underlie the staff's projection for the economy and financial markets. Our monetary policy assumption is indexed on growth of M2 of around 8-1/2 percent this year, after making a rough allowance for the effect of shifts of funds into MMDAs from sources outside M2; for 1984, we have assumed growth of M2 at 8 percent. These assumptions are consistent with short-run Alternative B in the Bluebook. The velocity of M2 in the projection increases somewhat in 1983 and 1984 following the unusually large decline in 1982. We believe the assumptions and the forecast are consistent with a little further rise of interest rates this year -- the 3-month Treasury bill rate averages 9-1/2 percent in the fourth quarter, about ½ percentage point above its current level; next year rates are projected to decline moderately.

The fiscal situation is presented in the next chart. Staff projections for receipts and outlays indicate actual budget deficits around $200 billion in both 1983 and 1984 fiscal years. These deficits on a structural basis rise from that in 1982, largely because of the personal income tax reductions effective July of last year and this July. Updated administration budget figures are not yet available, although it seems likely that the current fiscal year deficit will be close to that of the staff and lower in 1984, partly reflecting different economic assumptions.

Nevertheless, fiscal policy is an expansive force over the projection period and the actual budget deficits relative to GNP, shown in the bottom panel, are expected to remain historically large. At the present time we don't believe there is much possibility of a major change in the fiscal stance over the year ahead, given the administration's lack of enthusiasm for tax increases and deep cuts in defense outlays and the unwillingness of Congress to slash nondefense programs.

Mr. Zeisel will continue the presentation with a discussion of recent and prospective domestic economic developments.

* * * * *

Joseph S. Zeisel

FOMC CHART SHOW
July 12-13, 1983

The expansion in economic activity has accelerated considerably in recent months, and has taken on most of the characteristics of a typical postwar cyclical recovery. While much of the rebound in demand earlier this year was accommodated by reducing stocks, more recently the sustained strength of sales has generated a vigorous growth in production and employment.

As is evident in the left hand panels of the following chart, consumers have played a major role in the recent acceleration in economic activity. Sales of furniture and appliances have been particularly strong, associated partly with the recovery in housing. There has also been a resurgence in auto demand--as shown in the right-hand panel. Domestic models sold at a 7-1/4 million unit annual rate in June, up nearly a fifth from the level late last year, and the strongest pace in almost two years. As the bottom right panel illustrates, dealers' stocks are now relatively low and substantial upward adjustments have been made in scheduled assemblies for the next few months.

As shown in the next chart, industrial production overall has continued to rise strongly--by May, output was 7 percent above its trough 6 months earlier, about in line with its average performance in postwar recoveries. Available data suggest that production continued to increase at about this same pace in June.

Consistent with the growth in output, nonfarm payroll employment has expanded strongly, rising by 350,000 in June, with gains widespread. The rebound in factory production earlier in the year was associated largely with a snapback in the workweek, shown in the bottom panel; lately, however, employers have been shifting more to hiring to meet their labor needs, suggesting increased confidence in continued expansion.

The next chart presents our view of the outlook for growth through 1984. We now estimate that real GNP rose at about a 7-1/2 percent annual rate in the second quarter--higher than the forecast of the Commerce flash three weeks ago. Moreover, it appears that the stimulus to production from rising employment and income will carry over into the third quarter, with GNP advancing at close to the second-quarter pace. We expect growth to ease somewhat toward year end and in 1984, but as indicated in the bottom panel, we are forecasting a slightly stronger than average second year of recovery--4-1/4 percent. For the two years combined, the projected expansion of nearly 10 percent is close to postwar cyclical experience.

In the next chart, we have disaggregated GNP growth to highlight the contribution of the major components. Several elements--in particular, CCC payments and farm inventories--have been excluded because their erratic fluctuations have tended to obscure fundamental movements in GNP. As is evident from a comparison of the first and second panels, we expect real gains in private domestic final purchases--that is, consumption, housing and business fixed investment--to hold up quite well on average in the latter half of this year. The swing from nonfarm inventory liquidation to restocking, which was a major factor in GNP growth in the first half, becomes less important as the year progresses, but this is offset in part by a smaller decline in net exports.

In 1984 (the bottom panel), GNP growth slows as final purchases lose some momentum and the process of inventory rebuilding comes to an end, although the shift of net exports from a negative to a small positive contribution to growth partially offsets the deceleration elsewhere. Excluding CCC, federal government purchases are not expected to play much of a role throughout this period, and in fact these outlays grow a bit more slowly in 1984 in real terms as the rise in defense outlays moderates.

Among the components of final purchases, housing (shown in the next chart) has contributed significantly to the overall recovery to date. But we expect considerably less support from this sector for the balance of the projection period. The upper left-hand panel illustrates the close inverse correlation between starts and mortgage interest rates recently. As the right-hand panel shows, new home buyers responded vigorously to the reduced mortgage rates, and sales of new homes have nearly doubled since their lows early last year. But mortgage rates have moved up in recent weeks, and with some further rise in prospect, as shown in the middle panel, it appears likely that housing demand and home construction will soon begin to stabilize. We anticipate little further growth in activity until mortgage rates begin to edge off again next year.

The next chart addresses the outlook for business capital outlays. As shown in the upper left hand panel, recent data on new orders indicate that a farily healthy turnaround in spending for business equipment appears to be underway. In contrast, outlays for nonresidential construction have continued to drop since late last year--the right hand panel. Given current vacancy rates, we expect office building construction in particular to remain weak through next year. In contrast, real spending for business equipment should continue to strengthen in 1984 as corporate profits improve and the slack in unused capacity narrows. Based upon revised figures, we are projecting capacity utilization in manufacturing to exceed 80 percent by late 1984. On balance, as shown in the bottom panel, we are projecting a recovery in fixed capital outlays of about 11 percent over the two years--slightly under the average cyclical rebound--reflecting the continued weakness of nonresidential construction.

The next chart addresses the outlook for consumption. The top left panel illustrates the dramatic improvement in attitudes that accompanied the resurgence of consumer demand recently. The sharp run up in stock prices (right hand panel) helped enhance household financial positions and undoubtedly contributed to the increased demand for autos and other big ticket items. It is our view that consumer demand will remain vigorous over the near term given recent strong gains in employment and income, augmented by the stimulative effects of the July tax cut. We expect growth in consumer demand to moderate in 1984 as gains in real disposable income taper off. But given the improved state of household finances, outlays should hold up better than income; as indicated in the bottom panel, the saving rate is projected to remain relatively low in 1984.

As the next chart shows, we expect fairly steady improvement in the labor market to accompany stronger growth in output, although initially at least, much of the pickup in demand is achieved by rising productivity. The growth in employment next year should be greater, but, as shown in the middle panel, along with improved job opportunities, we also expect more rapid labor force growth. On balance, this will lead to a relatively slow decline in the civilian unemployment rate to about 8-1/2 percent by the end of next year--still quite high in historical terms. We expect employment in the industrial sectors to remain well short of 1979 peak levels, with especially high unemployment rates in some heavy industries.

As the next chart shows, the prolonged weakness in labor markets has contributed to a considerable easing of wage inflation in all sectors of the economy. The overall index of average hourly earnings rose at a 4-1/4 percent rate in the past half year, down from a 6 percent increase in 1982. We believe the levels of resource utilization that are projected for the next year will continue to act as a restraint on wage increases. Moreover, there will be continued benefits from this year's good price performance on cost-of-living adjustments, and agreements already in place generally have rather moderate wage increases built in for next year. At the same time, however, improved business and profit performance is likely to lead to some firming of wage demands and pressure for reversing wage concessions granted earlier. Next year's social security tax increase will also add about half a percent to compensation costs, shown in the bottom panel. As a result, we are projecting a 5 percent increase in these costs over 1984, slightly more than in 1983.

As the next chart shows, we expect continued strong cyclical gains in productivity to help in damping inflationary pressures this year. Productivity growth was surprisingly strong last year in the face of declining output, suggesting that firms may have made special efforts to cut costs, possibly signaling more lasting gains in efficiency, and we have adjusted up our estimate of longer-run productivity trends slightly. As growth in economic activity moderates somewhat in 1984, we expect gains in productivity to slow, in rather typical cyclical fashion, but for the year as a whole to remain slightly above our notion of the long-term trend. In conjunction with the slight acceleration in compensation, unit labor costs are projected to rise at about a 3-3/4 percent rate in 1984.

The outlook for inflation is presented in the next chart. It is clear that the recent moderation of overall price increases owes something to the strong dollar and its impact on nonpetroleum import prices. As is shown, import prices rise sharply again in 1984 as a result of the projected depreciation of the dollar. In addition, food prices next year may be moving up a bit more rapidly in response to a variety of government efforts aimed at raising crop prices and boosting farm income. Business is also likely to attempt to improve profit margins as demand firms. But fundamentally, given prospective labor cost trends and relative slack in markets, it appears that the risks of a substantial acceleration in prices are quite small. On balance, therefore, we are forecasting only slightly higher rates of inflation in 1984 than in the latter half of this year--a bit over a 4 percent rate of increase in the GNP deflator.

Mr. Truman will now discuss the international outlook.

E.M. Truman
July 12, 1983

FOMC CHART SHOW -- INTERNATIONAL DEVELOPMENTS

The first international chart shows that the weighted average foreign exchange value of the dollar has recently regained its level of last November. In nominal terms, depicted by the black line in the chart, the dollar is slightly above its previous peak, but the relatively better inflation performance in the United States than on average in other industrial countries has caused a widening gap between the nominal value of the dollar and its price-adjusted value, shown by the red line.

It is instructive to note that although the dollar has appreciated in nominal terms by close to forty percent since the end of 1980, its appreciation has been only slightly more than five percent in the past 12 months. Moreover, the dollar's appreciation during this period has been primarily against the currencies of countries with rapid inflation, such as France and Italy. Against the German mark, the Swiss franc and the Canadian dollar, the U.S. dollar has been essentially unchanged in value, while it has depreciated somewhat against the Japanese yen. Thus, the dollar has remained strong over the past year, but it has not appreciated substantially further. However, as is shown in the lower panel, the dollar's continued high level has persisted despite the elimination (until recently) of the differential between short-term dollar interest rates and rates on short-term assets denominated in other currencies.

We expect that over the forecast period movements of interest rates on foreign currency assets will be essentially similar to movements in interest rates on dollar assets. Therefore, the explanation for the projected depreciation of the dollar shown in the top panel -- which amounts to about 15 percent over the next six quarters -- must lie elsewhere. It will not surprise the Committee to learn that our explanation for the dollar's projected depreciation continues to lie in the unprecedented U.S. trade and current account deficits that we are forecasting. One factor contributing to those deficits is, of course, the continuing effects of the strong dollar during the past year. However, economic conditions abroad will also play a role.

The upper left panel of the next chart shows that average inflation has declined in the foreign industrial countries to a year-over-year rate of less than six percent. We expect this deceleration to continue over the forecast period, with an average inflation rate of around five percent prevailing at the end of 1984.

As can be seen in the upper right panel, industrial production in the major foreign countries has picked up since the end of last year, but through early spring that revival was relatively moderate, averaging less than 1/2 a percent a month.

The lower panel shows that the recent recession in the industrial countries abroad was less severe, on average, than the recession in 1974-75. We project that the recovery will also be more moderate. The contrast reflects, in part, the continuing need for macroeconomic adjustment in France and Italy. However, we are projecting a weak recovery in Japan and Germany as well, in large part because of tight fiscal policies and relatively weak external demand.

The foreign industrial countries, as well as the United States, will experience little or no short-run stimulus from exports to the non-OPEC developing countries during the forecast period. As is shown in the upper left panel of the next chart, the volume of imports of these countries is expected to decline in 1983 for the second year in a row and to record only a moderate increase next year. Meanwhile, their exports are expected to expand and their terms of trade -- whose components are shown in the upper right panel -- should stop deteriorating.

Reflecting these factors, the lower panel shows that the trade deficit of the non-OPEC developing countries is projected to be less than half as large in 1984 as it was in 1979. The improvement in the current account position of these countries will be less dramatic. The more moderate contraction reflects growing interest payments on external debts that have been bloated by past deficits and refinanced at higher interest rates.

The next chart summarizes the impact on U.S. external accounts of the relatively robust U.S. recovery, slack demand abroad and our forecast for the dollar. The upper left panel shows the continued decline this year in the volume of U.S. exports, while the volume of U.S. imports rises by about 20 percent. Next year, with a pickup of growth abroad and the projected depreciation of the dollar, the growth of U.S. exports should turn positive and that of imports should moderate.

On the price side, as is shown in the right panel, the average price of imports should continue to decline this year, reflecting in part the decline in oil prices. As Mr. Zeisel has noted, even with no change in oil prices next year, prices of imports should pick up significantly. Prices of exports are projected to rise at about a 5 percent rate both years.

The lower panel shows that in the fourth quarter of this year we are projecting a U.S. trade deficit of almost $100 billion at an annual rate, and a current account deficit of about $70 billion. We are also projecting that by the fourth quarter of next year the trade deficit will be close to $110 billion. The current account deficit will increase less -- to about $75 billion -- because the expected recovery abroad, along with the dollar's depreciation, should boost direct investment receipts.

As I have noted before, we are less certain than we would like to be about our forecast of the dollar's external value. For this reason, the next chart summarizes an alternative forecast based on the assumption that the dollar does not depreciate below its average nominal value recorded in the second quarter of this year.

The estimated effects of a stronger dollar on the U.S. trade and current account deficits this year are small and the deficits might even be reduced slightly, reflecting so-called J-curve effects, if the dollar does not depreciate. By the end of next year, however, the deficits would be increased, with the current account deficit about $10 billion larger. This estimated effect grows to about $25 billion by the end of 1986.

The effects of a stronger dollar on U.S. real growth and inflation are somewhat less dramatic. As is shown in the lower panels, real growth during 1984 would be reduced by about a quarter of a percent and consumer price inflation would remain at less than 3-1/2 percent instead of rising above 4 percent. The effects on real activity tend to wash out in later years, but the price level would be about 2 percent lower at the end of 1986.

A continued strong dollar would, of course, have other implications that are more difficult to quantify. Among these are the encouragement of protectionism -- here and, in response, abroad -- and the effects on the debt service burdens of developing countries.

Mr. Prell will now review the domestic financial outlook.

DOMESTIC FINANCIAL DEVELOPMENTS

The next chart presents a broad view of credit flows in the economy. The inset in the upper panel shows that, in the first half of this year, the debt of domestic nonfinancial sectors grew a little faster than nominal GNP. This is a reversal of the usual pattern for the early stages of economic recovery, but is consistent with our earlier expectations. As is reflected in the chart, we are projecting that debt growth will outstrip GNP growth for the year as a whole and again in 1984. We thus see the credit aggregate growing at about the 10% midpoint of the Committee's 8-1/2 to 11-1/2% range for 1983 and slowing only slightly in 1984. Looking at the components of that credit growth, what stands out is the behavior of federal debt, displayed in the bottom panel, absorbing an extraordinarily large share of the total credit flow as it expands at almost a 20% per annum rate in 1983-84.

Among the nonfederal sectors, the major increase in credit use this year has occurred in the household sector. As may be seen in the upper left panel of the next chart, growth of mortgage and consumer debt has accelerated sharply, supporting the key elements of strength in final demand--housing and consumer durables, especially autos. The survey results depicted in the right panel suggest that there has been a shift in consumers' attitudes away from the conservative financial posture they had assumed during the period of recession and record high interest rates. Despite the stepped-up borrowing, however, the household sector's financial net worth has continued to rise, buoyed especially by the surge in stock prices, and, as indicated in the bottom right panel, consumer loan delinquencies have remained low while mortgage delinquencies have shown signs of leveling off.

The financial condition of the business sector also has improved. The top left panel of the next chart shows the narrowing of the financing gap faced by corporations--reflecting first massive inventory liquidation and then the cyclical upturn in profits. As fixed investment gathers speed next year, the gap is expected to widen despite further sizable profit gains. Another aspect of reduced pressures on firms recently is reflected in the right-hand panel, which indicates that, in the aggregate, interest payments already command a noticeably smaller portion of cash flows. The securities markets, moreover, have been much more hospitable to firms seeking long-term funds. The improving economy has brought a narrowing of quality spreads in bond yields, indicated in the lower left panel by the yield differential between corporates and Treasuries, and better profit prospects and lower interest rates have produced a marked reduction in the cost of equity capital, as reflected here in the earnings-to-price ratio for the S&P 500. These improvements have been sustained even through the recent back-up in interest rate levels. Companies have been able to achieve considerable progress in reducing debt-equity ratios and, as indicated in the right panel, in lengthening debt structures. We are projecting, however, that as recovery proceeds next year short-term borrowing will again take on substantial proportions, bringing a halt to the balance sheet reliquification.

The next chart focuses on the state and local government sector. Many states and localities are still wrestling with financial difficulties, but, as the upper panel shows, in the aggregate a combination of spending cuts, tax hikes, and cyclical revenue improvements has moved the sector back into operating surplus. We are projecting some narrowing of the surplus in subsequent quarters as building and repair spending picks up and some tax measures lapse. The credit markets meanwhile have been very receptive to tax-exempt borrowers, allowing units to sell huge amounts of bonds for prospective spending purposes and for the refunding of higher cost debt. As the middle panel indicates, we see a considerable fall-off in state and local borrowing in the months ahead, owing to the end of the pre-registration bulge and to the rise in interest rates. This will not, however, mean any commensurate relief for the markets in terms of basic rate pressures, since, as the bottom panel shows, much of the money borrowed has been reinvested in other securities--especially Treasuries.

The next chart shows that some key lenders have benefitted along with borrowers from the cyclical drop in interest rates. Variations in the frequency of reporting and problems of seasonality complicate the construction of consistent time series covering all commercial banks. Nonetheless, if we focus on the data in the boxes, it is fairly clear that the earnings--especially of the bigger banks--have been boosted by the effects of declining rates on interest margins. Indeed, the improvement in margins was great enough to offset the impact of higher loan loss provisions in the past few quarters. Obviously, though, credit quality remains the major area of vulnerability for bank earnings, with still considerable risks of write-offs of both domestic and international loans. For thrift institutions, interest rates are the critical variable. The thrifts moved to roughly break-even operating positions in the first quarter, but no further improvement would seem to be in store over the remainder of the year, given our rate projection.

James L. Kichline
July 12, 1983

FOMC CHART SHOW -- CONCLUSION

The top panel of the next chart presents a summary of the economic projections of Committee members, the staff, and the administration. The bottom panel shows the ranges of 1983 projections reported to the Congress in February. As indicated by the median figures for Committee members, the current projections for 1983 are quite similar for all the parties. Compared to the outlook in February, upward revisions to projected real GNP have placed the current forecasts near the top of the earlier range. The unemployment rate projected for the final quarter of 1983 is now near the bottom of the range, associated with the strengthened outlook for economic activity.

For 1984, the various forecasts are not markedly different, although the staff is on the lower side of most forecasts for the GNP deflator and consequently for nominal GNP as well.

For your possible reference the last chart presents forecasts on a year-over-year basis.

* * * * *